**Q2. Is discharge of debt specifically included in gross income?**

As discussed in Q1, the discharge of debt is an economic benefit conveyed upon the debtor. In essence, a discharged debt is equivalent to receiving money (i.e., the amount borrowed that will never be repaid). As discussed in Q2A and Q2B, below, the context in which the debt is discharged will determine how it is to be reported. Assuming the forgiven debt is a “pure” discharge, however, it is deemed to be “income from discharge of indebtedness” specifically includible in gross income pursuant to IRC section 61(a)(12). For this purpose, pure discharge of debt requires an unconditional forgiveness for no consideration.[[1]](#endnote-1)

*Example*: Asher borrows $10,000 to take a 2 week European vacation. Two years later, when the loan becomes due, Asher defaults. In lieu of pursuing a legal collection action against Asher, the lender forgives the entire loan. Because the forgiveness of the loan was unconditional for no consideration from Asher, the $10,000 forgiveness is considered to be “income from discharge of indebtedness” includible in gross income under IRC section 61(a)(12).

**Q2A. Can discharge of debt that is not specifically included in gross income under IRC Section 61(a)(12) be included in gross income under any other section?**

Clearly, the discharge of the obligation to repay debt is an economic benefit received by the debtor. As discussed in Q2, above, the unconditional discharge of debt for no consideration is includible in gross income under IRC Section 61(a)(12). On the other hand, if the debtor provides consideration to the creditor, creditor is deemed to have paid the amount of the debt to the debtor as compensation, which, the debtor in turn used to repay the debt. Under those circumstances, the transaction is treated as an exchange of money for services or property rather than discharge of debt income includible under IRC Section 61(a)(12).

*Example*: Asher borrows $10,000 from his employer to take a 2 week European vacation. When the loan becomes due, Asher’s employer forgives the debt. Because of their employee/employer relationship, the amount of the discharged debt is treated as compensation (not income from discharge of indebtedness). In other words, it is as if Asher’s employer paid him $10,000 as compensation for services which Asher in turn used to repay the debt. Therefore, the forgiven debt is treated as wage income includible under IRC Section 61(a)(1) rather than IRC Section 61(a)(12).[[2]](#endnote-2)

*Example*: Asher borrows $10,000 from Ashley to take a 2 week European vacation. When the loan becomes due, in lieu of repayment, Ashley accepts a painting from Asher worth $10,000 that he purchased 3 years ago for $2,000. In this case, it is as if Asher sold the painting to Ashley for $10,000 which Asher in turn used to repay the debt. Similar to any taxable sale or exchange of property, Asher must include $8,000 of capital gain income ($10,000 minus $2,000 (basis in painting)) under IRC Section 61(a)(3).

**Q2B. Is it possible for a portion of discharged debt to be treated as “income from discharge of indebtedness” and a portion treated as some other type of taxable income?**

As illustrated by the following example, if there was partial consideration for the discharged debt, the transaction would be bifurcated.

*Example*: Asher borrows $10,000 from Ashley to take a 2 week European vacation. When the loan becomes due, in lieu of repayment, Ashley accepts a painting from Asher worth $8,000 he purchased 3 years ago for $2,000 and forgives the balance of the loan ($2,000). In this case, if is as if Asher sold the painting to Ashley for $8,000 which Asher in turn uses to partially repay the debt. For tax purposes, Asher must include $6,000 of capital gain income ($8,000 minus $2,000 (basis in painting)) under IRC Section 61(a)(3). As to the remaining $2,000, since Ashley forgave this amount for no consideration, Asher must include it in gross income under IRC Section 61(a)(12). Bottom line: Of the $8,000 of total income, $6,000 is capital gain and $2,000 is discharge of debt income.

1. Treas. Reg. § 1.61-12. [↑](#endnote-ref-1)
2. Treas. Reg. § 1.61-12. [↑](#endnote-ref-2)